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(1)



In the Supreme Court of the United States

OCTOBER TERM, 1942

No. 992

N. O. NELSON COMPANY, PETITIONER

v.

GUY T. HELVERING, COMMISSIONER OF INTERNAL
REVENUE

*ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED
STATES CIRCUIT COURT OF APPEALS FOR THE EIGHTH
CIRCUIT*

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The opinion of the United States Board of Tax Appeals (R. 33-41) is reported at 45 B. T. A. 899. The opinion of the Circuit Court of Appeals (R. 62-70) is not yet reported.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered on February 23, 1943 (R. 70); rehearing was denied March 16, 1943 (R. 77). The petition for a writ of certiorari was filed May 3, 1943. The jurisdiction of this Court is invoked under Sec-

tion 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTIONS PRESENTED

1. Whether in computing its surtax on undistributed profits the provisions of a certain written contract, as amended, entitle petitioner to a credit of its entire adjusted net income for the years 1936 and 1937 under Section 26 (c) (1) of the Revenue Act of 1936.

2. Whether in computing its surtax on undistributed profits the provisions of the contract in question entitle petitioner to a credit under Section 26 (c) (2) of the Revenue Act of 1936 in the amount paid its creditors in 1937.

STATUTE AND REGULATIONS INVOLVED

The pertinent statute and regulations are set forth in the Appendix, *infra*.

STATEMENT

The facts, which were stipulated, may be summarized as follows:

Petitioner, a Missouri corporation, was organized by the N. O. Nelson Manufacturing Company, also a Missouri corporation, hereinafter called the Manufacturing Company, for the purpose of continuing the business of the latter company in accordance with the terms of an agreement dated December 3, 1934, between the taxpayer, the Manufacturing Company, and sundry creditors of the latter (R. 33).

Under this agreement, the Manufacturing Company, which had executed a first mortgage deed of trust for the benefit of creditors, transferred certain of its assets to the petitioner in consideration of petitioner's entire authorized capital stock and its assumption of certain liabilities. The petitioner commenced operations January 1, 1935, with a capital stock of \$100,000 and a capital surplus of \$691,808.54. (R. 33-34.)

In accordance with the agreement, Spang, Chalfant & Company and the American Radiator & Standard Sanitary Corporation advanced the petitioner cash and sold merchandise to it on credit in the aggregate amount of \$120,000 each by March 31, 1936. It was agreed that this indebtedness was to be evidenced by notes of the petitioner endorsed by the Manufacturing Company. It was further agreed that 50% of the petitioner's capital stock was to be deposited with Spang, Chalfant & Company and the other 50% with the American Radiator & Standard Sanitary Corporation as collateral to secure payment of merchandise purchased by the petitioner on credit. The agreement also contained the following statement (R. 34):

All dividends, if any, upon said stock so deposited as collateral shall be paid only out of current earnings to the respective pledgees thereof to be applied on account of any indebtedness owing to them at the time of such payment. * * *

In order to secure additional time for the payment of this indebtedness, and for other purposes, an agreement dated January 21, 1936, was entered into between the petitioner, the Manufacturing Company, the American Radiator & Standard Sanitary Corporation, Spang, Chalfant & Company, and the Mercantile-Commerce Bank & Trust Company, the latter acting for the creditors for whose benefit the mortgage deed of trust was executed. In accordance with the terms of this agreement, the petitioner on April 1, 1936, executed promissory notes in the amount of \$120,000 each in favor of Spang, Chalfant & Company and the American Radiator & Standard Sanitary Corporation, to evidence the petitioner's indebtedness to those companies. Also, it provided that payments on the principal of the notes would not be enforced prior to April 1, 1941. No payments were made thereon in 1936, but in 1937 \$30,000 was paid on each note. (R. 34-35.) This agreement further provided as follows (R. 35):

6. (e) That all surplus funds not required for carrying on the business of N. O. Nelson Co. will be paid ratably to the American Radiator and Standard Sanitary Corporation and Spang, Chalfant and Co., Inc. and to the Mercantile-Commerce Bank and Trust Company, of St. Louis, on the notes of the N. O. Nelson Co., payable to the N. O. Nelson Manufacturing Company and pledged with the Trustee as addi-

tional security for the Mortgage Deed of Trust * * *.

9. The said agreement of December 3, 1934, * * * shall continue in full force and effect until April 1, 1941, and be in nowise altered, modified or impaired hereby, except to the extent that the same is hereby expressly modified.

The Manufacturing Company, beginning on or about January 1, 1935, made cash loans to petitioner which totaled \$110,000 by March 31, 1936. This indebtedness was evidenced by a promissory note of the petitioner dated April 1, 1936, which was made payable to the Manufacturing Company, endorsed by it, and deposited with the Mercantile-Commerce Bank & Trust Company, as additional security under the mortgage deed of trust. No payments were made on this note in 1936, but \$27,500 was paid to the Mercantile-Commerce Bank & Trust Company in 1937. (R. 35.)

For the calendar year 1935, the petitioner sustained a loss and for the calendar years 1936 and 1937 realized net income. Petitioner had an earned surplus for 1937 but none for the two years preceding; its original capital surplus remained substantially unchanged. (R. 35.)

The petitioner neither declared nor paid any dividends in 1936 and 1937 (R. 36).

The Board held that under the provisions of the contract in question, as amended, the petitioner was not entitled to a credit under Section 26 (c)

(1) of the Revenue Act of 1936, in computing its surtax on undistributed profits for 1936 or 1937 under Section 14 of that Act, but that it was entitled under Section 26 (c) (2) of the Act, in computing such tax for 1937, to a credit of the amount it paid its creditors from current earnings during that year (R. 37-38). Each party appealed from that part of the decision which was adverse to it. The court below sustained the Board with respect to the credit claimed under Section 26 (c) (1), but reversed the Board's ruling that petitioner was entitled to the credit claimed under Section 26 (c) (2).

ARGUMENT

The decision below is correct on both issues and presents neither a conflict nor a question of general importance.

1. Petitioner's argument under Section 26 (c) (1) is bottomed upon its theory that the dividend clause of the original agreement was incorporated into the amendment by reference. This theory, however, was correctly rejected by both the Board of Tax Appeals (R. 37) and the Circuit Court of Appeals (R. 66). Since the reference to dividends did not survive the amendment, there is no occasion to consider whether the section contemplates an express prohibition on payment of dividends, as the heading would indicate, or whether it requires only that the contract expressly deal with the payment of dividends.

2. Petitioner was not entitled to the credit claimed under Section 26 (c) (2) because the contract as amended contains no express provision requiring the earnings and profits of the taxable year to be paid within the taxable year in discharge of a debt.

The words of the provision relied on are "all surplus funds not required for carrying on the business." What amount is required "for carrying on the business" is not stated. Manifestly Congress did not intend the credit to depend upon the corporate discretion as to what amount of its earnings shall be used for the discharge of obligations. The credit is granted not where the corporation controls the situation, but where the creditors do.

Furthermore, the pertinent contract provision does not deal with the earnings and profits of the taxable year; it refers to "all surplus funds." That term is not defined in the contract, and its meaning is ambiguous. It may or may not have been intended to embrace funds other than current earnings. Section 26 (c) (2) requires that the contract deal "expressly" with the disposition of "earnings and profits of the taxable year"; the requirement is not to be satisfied by implication or inference. And the fact that payment is made from such earnings is quite immaterial. *Helvering v. Magnus Beck Brewing Co.*, 132 F. 2d 379 (C. C. A. 2d), certiorari denied May 10, 1943, No. 846, this Term; *Clover Splint Coal Co. v. Commis-*

sioner, 130 F. 2d 52 (C. C. A. 3d); *Nevada-Massachusetts Co. v. Commissioner*, 128 F. 2d 347 (C. C. A. 9th); *C. C. Clark, Inc. v. United States*, 126 F. 2d 292 (C. C. A. 5th); *Helvering v. Moloney Electric Co.*, 120 F. 2d 617 (C. C. A. 8th), certiorari denied, 314 U. S. 682.

Finally, there is nothing in the provision which requires that payment shall be made "within the taxable year." *Helvering v. Ohio Leather Co.*, 317 U. S. 102, 109. The words of the contract are "will be paid"—no time for payment is specified. It is to be noted too that the contract contemplates a determination by petitioner's officers at a time not stated, as to the amount which it shall retain "for carrying on the business" for a period not established; necessarily payment to the creditors named is to follow this computation.

CONCLUSION

There is no conflict and the decision below is correct. The petition for certiorari should be denied.

Respectfully submitted.

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MAY 1943.

